Our market

London remains a major business force

Our West End office portfolio is let at an average rent of only £40 per sq ft

Economic backdrop

Over the last 12 months we have witnessed some extraordinary events unfold across the world's main economies. In the second half of 2008 we saw severe dislocation in financial markets and a rapid erosion of business confidence. The failure of numerous financial institutions across the globe initiated the widespread downward correction in asset prices with equities, bonds and real estate all suffering dramatic reductions in values in the first nine months of the financial year. With the capital value of our IPD benchmark down over 42% since June 2007, it is likely that this recession will be at least as bad for property values as any since the Second World War.

What started in the financial services sector has since spread to the broader economy with job losses gathering momentum. Because employment levels and business expansion plans are key drivers of rental values, it is no surprise that substantial declines have been recorded throughout the UK property industry since spring 2008. With the UK economy expected to contract by over 3% in 2009 and by a significant amount in 2010, we can expect further downward pressure on rental values.

London's economy and property markets

London's position as a global financial centre has meant that its economy has suffered the full force of the financial and wider business crisis. The major banking, insurance and professional service firms that drove employment during the middle of this decade have retrenched rapidly. Although difficult to calculate accurately, it is estimated that over 120,000 jobs have been lost in the F&BS sector since 2007 and by 2011 the total number of positions eliminated will exceed that seen in any downturn since the 1970s. These factors will serve to impact occupational markets as described in more detail below.

Despite this negative near-term outlook, London remains a major business force amongst the world's capital cities and offers significant attractions to both businesses and tourists alike with its heritage, scale, infrastructure, language, legal system, abundance of highly skilled workers and geographical location. In the medium term, all of these factors will aid the recovery in our real estate markets.

Occupational markets

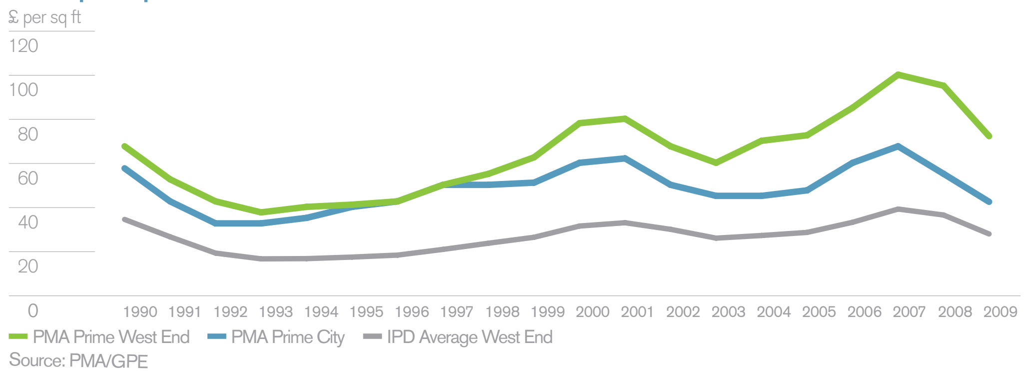
West End

Despite a limited supply of new landlord controlled space coming on stream in the West End, the level of occupational demand has been more relevant in determining the direction of rents. In the year to 31 March 2009, take-up of new office space was 3.7 million sq ft, 31% down on last year. Tenant controlled, or sub-let office space has also been released onto the market in greater volumes than during 2008. As a result, West End office vacancy rates have risen from 4.5% in March 2008 to 9.2% at the year end (with the core of the West End faring better than fringe areas) and prime headline rental values have fallen by 32% over the year. In the more value orientated segment, as illustrated by IPD average rents, declines have been less marked and are down 20% over the same period. Looking forward, whilst new development starts are rare, subdued occupational demand suggests depressed take-up for 2009 and 2010 and further falls in rental values, particularly in the higher value rental bands. Our own West End office portfolio is let at an average rent of only £40 per sq ft, despite its concentration in some of the most valuable parts of central London.

The West End retail market (comprising 29.9% of our West End portfolio by rent roll) has been less affected by the downturn than the rest of the UK retail market as retail sales in central London have outperformed other areas. In the three months to 31 March 2009, retail sales in London were up 5.8% compared to the same period last year versus a 0.7% contraction for the UK as a whole. This comparative resilience is partially explained by the popularity of London with foreign tourists who are currently benefiting from favourable exchange rates.

IPD central London total return index down 27.5%

Rents per sq ft



Source: PMA/GPE

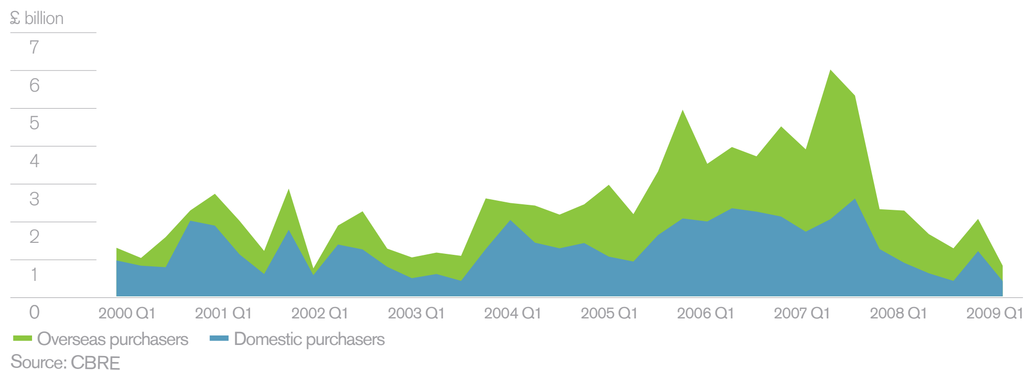
City and Southwark

In the City, materially lower letting activity and the increased supply of new office space have pushed vacancy levels up to 11% at 31 March 2009 (2008: 7.9%) and headline prime rents down by 22% since the start of the financial year, or 33% after adjusting for increased tenant incentives. Although the once large development pipeline has been scaled back due to the deferral or cancellation of a number of proposed schemes, with 3.9 million sq ft currently under construction and continuing weakness in occupational demand, the market balance in the City is likely to worsen further during 2009 and 2010. In Southwark, although there is a low level of supply and a more diverse customer mix than the City, take-up levels this year have been affected by difficulties in neighbouring financial districts and rental values have also fallen.

Investment markets

Poor sentiment as a result of global economic conditions, weak occupational markets and severely constrained credit markets have all contributed to the radical reduction in property investment market turnover which is down 66% year on year. Property investors have reacted to deteriorating confidence and weakening rental income prospects pushing our benchmark of IPD central London total returns down 27.5% in the year to 31 March 2009. CB Richard Ellis's prime West End benchmark yield has increased by 50 basis points during the year and stood at 5.5% by the end of March. The main driver of valuation movements switched from yield expansion to rental value contraction in the final quarter of the financial year as investors showed signs of being attracted to elevated income yields on selected, well let assets.

Central London investment transactions



Source: CBRE

Lead indicators

Property markets are cyclical and although we are in a downward phase at present, there will be stabilisation and growth in due course. To help identify the turning points of a cycle, we monitor numerous indicators and trends. Some of the key measures for the Group are as follows:

Property capital values

– equity and bond prices;

– changes in new lending by major UK and European banks;

– transaction volumes in central London direct real estate investment markets; and

– direction of pricing on IPD based derivative contracts.

Rental values

– UK GDP growth or decline;

– retail sales;

– business confidence levels in the central London economy;

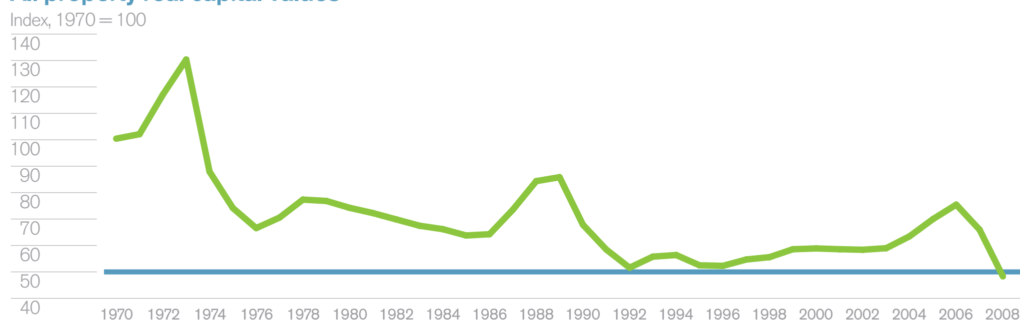
– output from the financial and business service sector; and

– finance and business service employment statistics.

In the first quarter of 2009 equity and bond prices have recovered from the dramatic falls experienced in 2008. Sentiment in the credit and direct investment markets has improved recently but remains fragile, particularly for lot sizes of over £50 million. We expect that the trough of the property capital value cycle will arrive before rental values begin to improve, and several commentators believe that capital values will stabilise during the second half of 2009 or early 2010.

Following this extraordinary period of falling asset prices, adjusted for inflation, central London property is now valued at broadly similar levels to that of the last major downturn in the early 1990s.

All property real capital values



Source: IPD